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News

California's GO Bond Rating Lowered Two Notches to 'A+'

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NEW YORK (Standard & Poor's CreditWire) April 24, 2001--The rating on the state of California's GO bonds is lowered to single-'A'-plus from double-'A'. The rating remains on CreditWatch with negative implications, where it was placed Jan. 19, 2001. Associated state appropriation-backed lease ratings are also revised, as well as those ratings for the California Health Facilities Construction Loan Insurance Fund (Cal Mortgage) that are secured by the full faith and credit of the state.

The downgrade reflects the mounting and uncertain cost to the state of the current electrical power crisis, as well as its likely long-term detrimental effect on the state's economy. Given the large magnitude of the problem in relation to the size of fund balances the state typically budgets, the capacity to pay debt service, while still adequate, has been reduced.

The rating has not been further reduced at this time due to:

- The state's still positive fund balance,
- Its deep and diverse economy, and
- The possibility that a proposed revenue bond will reimburse the general fund for power purchases already made -- although this revenue bond will not eliminate the gap between retail rates and purchased power.

The gap will continue for at least a year and will merely be pushed to a revenue bond account borne by ratepayers, with the expense for any substantial rise in purchased power costs above current projections likely to be carried again by the state's general fund. If the state cannot sell its proposed revenue bond as planned in a timely manner, the potential effect on the state's general fund could be severe without large further retail rate hikes beyond the sizeable percentage increases recently implemented.

The state's GO rating was placed on CreditWatch with negative implications on Jan. 19, shortly after the state purchased power to avoid blackouts caused by the insolvency of two investor-owned utilities (IOUs). These IOUs had become essentially insolvent after purchasing power for more than six months at rates substantially higher than they were able to pass on to their retail customers. One of the IOUs, Pacific Gas & Electric, declared bankruptcy April 6, 2001.

In January, the state indicated that a resolution of the problem would entail a state general fund contribution of less than $1 billion and that the problem would be resolved in a few months, at most, before long-term power contracts could be negotiated at substantially lower prices. Since then, the problem has escalated quickly. The state has spent more than $5 billion of general fund monies to date for purchased power and is likely to face a summer of power shortages and uncertain power prices at rates substantially above those charged to retail customers. The state has experienced blackouts and faces the very realistic possibility of extensive blackouts in the coming summer months. At a March meeting, the California Public Utilities Commission (PUC) substantially raised retail rates on heavy consumers of electricity effective in May; however, this increase is still not expected to fully match the cost of purchased power in the near term, if debt service for a proposed "rate smoothing" revenue bond is factored in. The PUC in March estimated that slightly more than $3 billion in new annual revenue would be generated in May by the recent rate order. However, the "net-short" has been running $1.5 billion-$2 billion per month since last summer and the state has been covering an increased "net-short" position of well over $70 million per day since the PG&E bankruptcy.

The governor's office has planned a $10 billion-$14 billion revenue bond issue to reimburse fully the general fund's cumulative contribution to date for purchased power, as well as to essentially "deficit finance" power purchases for the near term. The revenue bond is expected to provide breathing room through the anticipated high-cost summer months until the fall, when long-term power contracts will become effective. If this revenue bond, plus an associated earlier bridge loan financing, can be sold successfully, the state's general fund balance could be restored at least temporarily.

However, substantial uncertainty remains as to the final cost to the state of the power crisis. To begin, the cost of purchased power this summer, almost completely from the short-term market, will be hard to project. The long-term power contracts expected to go into effect this fall still will not cover all of the state's power needs. Market power purchases, some of which might be at very high prices, must supply the shortfall. To the extent that some of the generators are off-line, as is the case currently, the problem of high power cost will be compounded. Rate increases appear difficult in the present political environment, and related voter initiatives, although none are currently on the ballot, remain a possibility. Significant uncertainty exists as to the elasticity of demand in the face of rate increases, as this will be the first rate increase in many years. Several practical and legal hurdles also remain to the successful issuance of power revenue bonds, the chief one being the uncertainties related to the power of a bankruptcy court to hold onto anticipated pledged revenues or to interfere with PUC actions.

In addition, it is not unreasonable to expect past and future blackouts to affect business location decisions, and hence the ultimate direction of the state's economy.

Should any of these uncertainties materialize, the state's general fund ultimately remains the backstop of last resort for unexpected emergency purchases of power, due to the insolvency of the IOUs and the difficulty in raising retail rates. Appropriating general fund money to meet shortfalls requires a two-thirds vote of the state legislature. The state has often had trouble passing a budget by its June 30 deadline and a two-thirds legislative approval requirement for appropriations, plus the political upheaval caused by fallout from the crisis, may make timely passage of a fiscal 2002 budget difficult. In the final analysis, the state's power crisis will continue until an adequate amount of new generating capacity comes online.

The state projected in January that fiscal year-end June 30, 2001 would show an unreserved general fund balance of $5.5 billion, or 6.9% of expenditures, substantially more than the 1.9% unreserved fund balance originally budgeted due to strong economic growth in the first half of the fiscal year. The governor's scheduled mid-May revision in his budget proposal for 2002 will give greater insight as to economic conditions and the important level of April 2001 income tax collections. Because the state historically budgets only a small year-end unreserved fund balance, a small change in economic conditions can leave the state in negative fund balance territory. Fortunately, in recent years, budget assumptions have been quite conservative and recent years, budget assumptions have been quite conservative and continuation of this practice may provide some continued breathing room in the expenditure of state resources. However, the state's general fund financial resources are not sizeable enough to solve the power crisis alone on a permanent basis and the large magnitude of the contemplated revenue bond financing, some of which will be taxable so as not to overwhelm the tax-exempt market, is a sign of manageable, but still evident, fiscal stress, Standard & Poor's said. – CreditWire

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